

Paul Fisher: Regulation and the future of the insurance industry

Speech by Mr Paul Fisher, Executive Director for Insurance Supervision of the Bank of England and Deputy Head of the Prudential Regulation Authority (PRA), at the Westminster Business Forum conference, London, 22 January 2015.

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Introduction

Thank you for inviting me to speak to you today.

First, I would like to introduce myself. I have been both an academic and a long-term central banker, working across the Bank of England in various roles including as a specialist economist, private secretary (to Eddie George), Head of Foreign Exchange and then Markets Director. I have been on the MPC and the interim FPC. In 2014 I took on the role of Deputy Head of the Prudential Regulation Authority and I attend the PRA Board. Since mid-2014 I have also been covering as Executive Director of Insurance. In taking on this role temporarily, I have promised to maintain a regular and open dialogue with the industry; enable the delivery of Solvency II; and embed insurance supervision as part of the Bank of England.

I welcome the opportunity to discuss today's topics and the role regulation will play. However, I would also like to acknowledge some of the broader challenges facing the insurance industry.

Those challenges include the prevailing low interest rate environment; the consequent influx of alternative capital, especially into reinsurance markets; the transformation to the "at retirement" taxation system in the UK; competition in general insurance from overseas locations, possibly linked to regulatory arbitrage; as well as the new Solvency II regime.

I plan to focus my time mostly on Solvency II; but will also touch on the "at retirement" taxation changes.

Before that, I would first like to reflect upon the role insurance plays in the wider economy:

- Insurance is a critical cog in a financial services sector which facilitates trade and commerce and the efficient allocation of resources. Without a fully functioning financial services sector, the economy would stagnate. That importance of financial services to growth should be one of the big lessons of the Great Financial Crisis for anyone who did not appreciate the fact previously. More specifically, the insurance sector provides a critical risk-transfer role and is a vital long-term investor in the economy.
- The UK insurance industry is also an end-contributor to UK output and employment – being the largest insurance industry in Europe and third in the world.

The UK insurance industry is known for its innovation and entrepreneurialism, typified through the modest beginnings of Edward Lloyd's coffee house. The role played by the insurance sector in future will be contingent upon maintaining that tradition of competition and innovation and the PRA is committed to support that, not least through our secondary objective in respect of competition.

A safe and sound firm is a pre-condition for the continuous availability of critical financial services and for delivering effective competition. A healthy, profitable industry is entirely consistent with the aims of regulation. Indeed, a lack of profitability is a worrying sign for a supervisor.

Solvency II

Central to our goal of preserving a healthy insurance sector will be the successful implementation of Solvency II.

We are now well and truly into the “implementation phase”.

Solvency II will be going “live” in less than 12 months. Transposition of Solvency II into the UK rulebook is underway and we will be open for applications for internal models, matching adjustment etc from April 1.

Successfully landing Solvency II is a top priority for the PRA and the Bank. It will introduce:

- greater transparency;
- a level playing field through greater EU-wide co-operation;
- an enhanced approach to groups;
- greater co-operation arrangements between European regulators;
- transformed data collection and analytics;
- a greater emphasis on high quality governance; and above all
- a more risk-sensitive regulatory framework.

Considering how much effort has gone into, and is still going into, its development and implementation, I think it is worth reflecting on the core purpose and objectives of the new regime.

A main objective of Solvency II is the adequate protection of policyholders.

As I stated earlier, insurers play an important risk-transfer role. In some instances, individuals rely absolutely for their future lifetime incomes on the continuity of their insurance cover. To achieve an appropriate level of policyholder protection, insurers must be, and be seen to be, safe and sound.

I have said this before but I think it is worth reiterating. The PRA believes the UK industry is in a good position, having had the UK risk-based ICAS regime for around ten years. We are therefore **not** looking to use Solvency II as an opportunity to raise capital requirements across the board.

We do, however, recognise and respect that Solvency II is a maximum-harmonising Directive with a key objective of promoting supervisory co-operation. The PRA is committed to upholding this valued objective and will implement the Directive as intended. We can't and won't gold plate.

Our approach has been, and will continue to be, proportionate in our supervision. As a judgement-led, risk-based regulator, this principle is already part of the PRA approach. It is not the PRA's role to make sure no insurer fails. However, we are concerned that any failure is orderly and manageable. We seek this in conjunction with appropriate policy holder protection. For example, when business models become challenged we may seek to secure manageable and orderly wind-down, as has been seen in the past in this sector. In fact, roughly one third of insurers authorised by the PRA are in some form of run-off.

More than just a capital regime, Solvency II strengthens the linkage between capital and risk management. Solvency II will introduce an enhanced system of governance standards – promoting the embedding of a strong risk culture, demonstrable within the day-to-day operations of insurers.

The new regulatory regime will not look to fix firms' business models to be identical, nor to restrict the level of innovation across the market. Rather, Solvency II seeks to promote a better understanding of the risks being taken, allowing insurers to take informed decisions.

It is for firms' management to decide upon their chosen risk appetite and the precise details of their risk models. What matters to the PRA is that firms hold capital commensurate to such risk exposures, in line with the Directive.

The introduction of the Prudent Person Principle is an example of how risk management and strategic decision making will be owned by the insurer and its management.

The Prudent Person Principle will require investment decisions to be made as if being decided upon by the objective "prudent man" and represents a shift from quantitative to qualitative rules. Gone are the old investment limits for asset classes. So insurers will have much more freedom in their investment choices.

The PRA does not and will not promote one asset class over another. There are two aspects to this: we recognise that life insurers can be an important source of long-term, stable financing for corporates, infrastructure and mortgages – this is an important function that we want to see maintained; but we also must consider the wider financial stability angles, avoiding undue influence on the asset allocation behaviour of insurers.

Solvency II should not materially drive investment decision making except in so far as it helps to make certain that insurers fully understand the risks that they take. The Prudent Person Principle will seek to ensure that the industry understands and is capable of managing its investment risks. Specifically, insurers must be able to demonstrate that they can properly identify, measure, monitor, manage, control and report on their investment risks and not place reliance upon information provided by third parties. Investment choices should be made in the best interest of policy holders and beneficiaries.

Those running a business are best placed to make business decisions. That being said, the PRA does have the benefit of perspective. The PRA has the ability to look across the industry and can also draw upon the expertise of specialists working across the different areas of the Bank of England.

Whilst on the subject of the role of management, we understand that there has been some uncertainty around our expectations of the non-executive director role for firms that have internal risk models.

Non-executive board members need not be technical experts in risk modelling. However, each board collectively should understand the key strengths, limitations, and judgements within their model. Over-reliance on a single measure can be misleading. Therefore, we want non-executives to have the right tools and sufficient knowledge to be able to challenge model outputs, rather than follow them slavishly.

Benefits to be gained through the implementation of a harmonised regime

I have discussed the increased flexibility to be afforded firms in business and investment decisions and the expectations placed upon insurers in their knowledge and understanding of the risk exposures and their models. But I would also like to consider the benefits to be gained through the implementation of a harmonised regime.

The benefits of Solvency II do not come from the improved prudential regime alone. Insurance markets across the EU have been fragmented. The move towards a more co-operative framework will widen existing opportunities and help create new ones.

The new framework seeks to introduce a level playing field across the EU, with risk-based capital standards and robust valuation practices that, together with enhanced disclosure rules, encourage the effective exercise of market discipline through the increased provision of information.

From a systemic point of view, a more coherent and understandable regime should enhance confidence in the European insurance industry. This is particularly important at a time where weak real growth is leading to low levels of inflation and interest rates.

Financial markets have become increasingly interconnected and that trend has only been slowed temporarily by the global financial crisis. The PRA therefore welcomes the more rigorous approach to group supervision that will be introduced by Solvency II. This will lead to a much more joined-up approach between regulators through the operation of colleges. Enhancing information flows and producing equivalent and comparable data should make European colleges easier to operate – leading to more effective supervision and enhanced co-ordination among national supervisory authorities.

We think that the UK has been ahead of the game with the ICAS regime. But it is important that there is a more rigorous rulebook across Europe to allow more effective supervision in an interconnected world.

Challenges ahead

As I mentioned earlier, the industry is currently facing a number of other challenges.

In particular the changes to the UK taxation system of the “at retirement” market, the impact of which is already significant on some insurers’ business models.

Change to the annuity market will also bring about:

- New / untested risk exposures;
- Increased competition;
- A need for enhanced support for the consumer; and
- Potential redistribution of pension pot monies.

Changes to business models will naturally lead to changes in risk exposures which will need to be carefully considered and managed. Through these changes, it is imperative that we continue to learn and adjust, working openly and transparently with the industry.

I hope you will agree when I say the PRA has demonstrated its commitment to working with the industry – as seen with the UK securing the matching adjustment in Solvency II as part of the long term guarantees package. The matching adjustment has been something the UK advocated strongly in the triologue negotiations. We do recognise that certain annuity firms can afford to invest in less liquid assets.

The PRA also introduced the ICAS+ process as a way in which to constructively deal with the delays to Solvency II implementation but also to provide useful and practical way to feedback to industry on the progress being made to their internal models.

Now is an important juncture for the insurance industry as a whole. As such, we will need to work closely with industry (as we have done in the past) to get the best outcome.

This is also a time of increased opportunity. By pursuing Solvency II and our statutory objectives, we will make our contribution to the sustainability of the insurance industry.

I hope today has given you a good sense of the overall approach the PRA is taking and our commitment to ensuring a strong and resilient insurance sector.

Thank you